NATIONAL DEFENSE UNIVERSITY

NATIONAL WAR COLLEGE

INFORMED QUESTIONS PAPER: TURKISH ECONOMIC ISSUES

LTCOL JOHN K. DODGE
5604
THE GLOBAL SECURITY ARENA
SEMINAR A

PROFESSOR
DR. ROY STAFFORD

ADVISOR
COL MARK PIZZO

Report Documentation Page

Form Approved
OMB No. 0704-0188

1. REPORT DATE **2002**	2. REPORT TYPE	3. DATES COVERED **00-00-2002 to 00-00-2002**
4. TITLE AND SUBTITLE **Informed Questions Paper: Turkish Economic Issues**		5a. CONTRACT NUMBER 5b. GRANT NUMBER 5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)		5d. PROJECT NUMBER 5e. TASK NUMBER 5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **National War College,300 5th Avenue,Fort Lesley J. McNair,Washington,DC,20319-6000**		8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)		10. SPONSOR/MONITOR'S ACRONYM(S) 11. SPONSOR/MONITOR'S REPORT NUMBER(S)
12. DISTRIBUTION/AVAILABILITY STATEMENT **Approved for public release; distribution unlimited**		
13. SUPPLEMENTARY NOTES		
14. ABSTRACT **see report**		
15. SUBJECT TERMS		

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**		**11**	

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std Z39-18

Informed Questions Paper: Turkish Economic Issues

Background: Facing decreased foreign investment, massive and historic levels of inflation and the lowest levels of productivity in decades, the Turkish government launched an extensive economic reform program in 1999 to defeat the entrenched pattern of high inflation and restore sustained growth. In a demonstration of unprecedented unity, the three party coalition government began the momentous task of modernizing the role of the state in the Turkish economy, in an effort to remove the legacy of autarky that was engrained in the "statism" side of the six arrows of Kemalism. Inherent in this undertaking, the government initiated steps to address deep-rooted social and environmental problems that had characterized Turkish society for generations**.**

The Government's economic reform program is based upon three core elements: (1) a strong fiscal adjustment to put public finances on a sustainable path; (2) major second generation structural reforms in agriculture, pensions, banking, energy and telecommunications; and (3) a shift to forward indexation to lower inflationary expectations. [1]

Sensing the seriousness and commitment with which the Turkish government was addressing the economic reform, the International Monetary Fund, with World Bank and American support, initiated an unprecedented economic reform loan package to provide aid in Turkey's reform efforts.

Issue 1 - Foreign Direct Investment: Like the vast majority of big emerging economies, Turkey is dependent on foreign investment to bankroll the capital flows required for optimum market productivity and sustained development. The historic record of foreign investment in Turkey has been one of boom and bust. During the early to mid part of the 1980's both the domestic capital flow (from residents) and direct foreign investments into the economy continued to shrink and reached a low point of less than $100 million in 1987. Rebounding from the effect of President Ozal's reform initiatives, the cycle of direct investment and internal capital expenditure increased to healthier levels reaching $800 million in 1992, maintaining a steady rate that averaged $600 million annually until 1998. Since that time foreign investment is down to 1987 levels signaling the inability of the Turkish economy to sustain a significant positive capital flow of both domestic and foreign investment. For monetary support to continue from the International Monetary Fund (IMF) and the World Bank, Turkey must demonstrate the ability to win back foreign investors on a consistent basis, maintaining the boom without the bust.[2] **Question(s):** What economic reform measures have been implemented to win back foreign investment and have those efforts been successful to date? What additional measures are planned to increase the short-term domestic capital flow for the private sector?

Issue 2 - Projected Inflation Target. While undertaking an aggressive program of economic reform, a fierce devaluation of the lira hit Turkey during February 2001 that according to some international banking and financial house estimates set back the Turkish disinflation process by several years. On the heels of this devaluation the Turkish stock exchange lost 70% of its value in 2001 US dollars and further reduced the incentive for continued foreign investment. Reform measures continued to focus on controlling inflation by reduced government spending and implementing a policy of tight monetary control. A positive indication that reforms are having an effect is reflected in the lower inflation rates since the 2001 crisis. Inflation has come down from its triple digit highs and is now hovering around the 40 to 45 percent mark.[3] **Question(s):** What is the targeted rate for inflation in the 2003 timeframe and does the International Monetary Fund have a set target level in place as a requirement for continued monetary support? Do you believe the inflation controls currently put into effect will sustain a continuous drop in inflation and at what point do you foresee the inflation rate will level off? What is the target rate of inflation for Turkey for the next 5 years? What is you estimate of commercial interest levels and their comparative sustained inflation rates?

Issue 3 - Continued Political Consensus During Economic Crisis. The financial crisis that hit Turkey in February 2001 highlighted the vulnerability of Turkey's economy to its rapid level of reform and the political shock of economic crisis. It also called the then implemented International Monetary Fund (IMF) reform program into question. While the collapse of the lira was a significant event in its own right, the strain brought Turkey's leaders to their culminating point and forced them to face the reality of international financial disaster for the Turkish economy. The strain on the government leaders braving the hard road toward reform is significant, only offset by the failure to act. The need for a political consensus on critical economic reform raises concerns about the ability of the coalition to shoulder future economic setbacks and remain focused (and unified) on required reform. **Question**: What impact did the economic crisis (crash of the lira) of last year have on the political cohesion of Turkey's three party coalition government and what steps were implemented to ensure continued and viable IMF reform support?

Issue 4 - Economic Reform in a Legacy of Autarky. Implementing a policy of tight monetary control, reduced government spending and an increased level of personal and corporate taxation are actions that go against the long established economic character and practice of previous Turkish governments. The buzzwords surrounding the European Union (EU) members (and those desiring membership) are; autonomy, devolution, regionalism and subsidiary – terms and characteristics that also go against the historic grain of Turkish nationalist authority. A review of Turkey's historical governing context finds the Kemalist legacy of autarky as its guiding light with little deviation in financial practice for over 80 years. While Turkey's leaders still maintain the imperative of sacred and indivisible unity of the state, several leaders starting with Ozal and now present in the actions of the three party coalition government have tried to disentangle the state's authoritarian ways from the economy. **Question:** Given the severity of the current economic crisis in Turkey, the economic charter requirements for EU membership and the need to sustain fiscal control in order to maintain IMF and World Bank Support, is the long standing policy of autarky in Turkey's economic policy gone for good? Do you believe the reduction of direct state ownership and control of the economy and direct control of the banking infrastructure will lead to a reduction in the authority of the government and an ultimate decrease in it's economic influence?

Issue 5 - Economic Challenge of European Union Membership. By the vast majority of accounts, the prospect of EU accession is a positive factor in the Turkish economic reform equation and provides an objective to rally around for those seeking to move Turkey forward. The integration process with the EU requires over 31 chapters of conformation and is currently supplemented by the IMF and World Bank backed Disinflation Program and the Structural Reform Program launched on 1 January 2000. Together these particular programs are aimed at establishing the rule of law, transparency and accountability in the Turkish economic system by encouraging effective tax collection and a methodology to limit the size of the "unregistered" or "black-market" economy, currently estimated to total $100 billion (US dollars) of untaxed production. Comparatively, the official "taxed" gross national product of Turkey was approximately $200 billion (US dollars) for calendar year 2000. This comparison illustrates one of the many faces of the Turkish economy. The unregistered "untaxed" or "shadow economy" is a full 1/3 of the gross national product and when added to the legitimate product makes Turkey the world's 17th largest economy and allows the economic system to prosper by "Turkish" standards. At the same time this cycle of under the table business is costing the government millions in tax revenue as well as the level of market legitimacy required by Western standards - foremost in established EU standards. As the firewall, in addition to drastically changing the face of the economic system, the EU membership process requires integration of the Turkish legal system with the legal system. In this integration the EU courts will retain the highest authority, again pulling at the nationalistic heartstrings of Kemalism.[4] **Question(s)**: What reform policies and laws have been set in place to develop control of the Turkish unregistered economy? Are these measures working? Has the challenge of the reform measures (required to regain control of the Turkish economy) had a negative affect on the overall stability of the Turkish government? Has the prospect/requirement to subordinate Turkish law to the EU judicial system given strength to supporters of the Turkish anti-reform movement? Not only because of its geographic position but also due to its cultural, ethnic and religious demographics, Turkey is a bridge between European, Central Asian and Mid Eastern markets and institutions – will membership in the EU hurt Turkish influence in Central Asian and Mid Eastern markets?

Issue 6 - Second Generation Economic Structural Reforms. The Turkish government's economic reform program is largely based upon major second generation structural reforms in agriculture, pensions, banking, the energy production and distribution industry and telecommunications. Previous attempts to reform these gigantic sectors independently have not achieved the results necessary for continued development, self sustained growth and a realistic level of economic viability defined by the most basic method of value measurement; a positive cash flow. **Question(s):** Compare and contrast these second-generation structural reforms to their first generation counterpart – Have these reforms met the government's expectations to date? Will adjustments be required and if so, what will those adjustments entail?

Issue 7 - Inflation and Wage Control. Turkey's principle economic problem is its continued high inflation, fueled by historically large public sector deficits and ingrained inflation expectation. Annual consumer price inflation has averaged 79% since prices began to escalate in 1988 and wholesale price inflation has averaged 75% over the same period. In past attempts to reduce the impact of inflation on the people, the Turkish government began to regulate some goods to lesson the economic pain on low-income households. The prices of bread, sugar, tea, energy and public utilities were regulated. Because of Turkey's large public sector employment pool, the government also exerts large control over wage rates and pension rates, often out of step with international norms. A prime example of this is the pre-reform retirement age of 42 for male civil employees.[5] **Question**: Does the Turkish government still employ a policy of price controls and does the future reform plan include price and wage control as part of its economic reform strategy?

Issue 8 - Economic Reform and Measures to Prevent Corruption. On the direct heels of the economic reform and privatization process, large conglomerates and entrenched beaurocrats began to make their focused and coordinated bids for a piece of the state owned pie, ready for sale to the private sector. The privatization process became so suspect that the government started to broadcast auctions of state-owned firms on live television. For all appearances this practice proved to be a viable and innovative method to reduce corruption.[6] **Question(s):** In the final determination, was the practice of televising sales of government assets and infrastructure an effective methodology for controlling certain aspects of corruption? Is the method of broadcasting government auctions still being employed? Has the level of corruption been reduced as the privatization process continues to unfold (Gas sector as model) and if so, what methods have been employed to further assist in removing all negative factors from the market place?

<u>Issue 9 - Turkish Economic Reform and Privatization Plans</u>. One of the "6 Arrows" of Kemalism, "statism" has its roots deeply imbedded in the Turkish Nationalist heart and remains at the core of Turkey's slow move to privatization. Responsibility for privatization in Turkey is divided between the Privatization Administration, the Ministry of Energy and the Turk Telecom Tender Committee. Some investors have suggested that delays in privatization can in part be blamed on confusion over agency responsibilities. Anticipated levels of privatization regarding Turkey's state owned institutions are an often-referenced requirement for continued IMF economic assistance.[7] **<u>Question(s)</u>**: What degree (by percent) of privatization of government owned assets is included in the Turkish Economic Reform Plan framework? What are the overall individual responsibilities of the three Turkish Privatization Agencies? Is there any truth to the allegations that problems within the three responsible agencies has led to reduced levels of both foreign and domestic investment?

<u>Issue 10 - Turkish Banking System Reform.</u> For decades state owned Turkish banks have been among the most profitable in the world, however, the risks they are willing to assume are notorious in financial circles and would make any Western banker pale. Scoring huge profits throughout the free lending/spending 1990's period of growth, State banks played a very significant role in the initiation and development stages of the Turkish financial crisis of February 2001. Lending freely to fulfill the need of Turkey's huge public sector demand for cash, the banks were hit by four main shocks: sharp increases in funding costs due to the increase of interest rates and a maturity mismatch, capital losses due to a sharp change in the foreign exchange rate and deterioration in asset quality and deterioration in the repayment ability of borrowers. The Turkish government initiated a second reform program in the Spring of March 2001. This time around the banking sector was included as a primary reform target. One of the main pillars of the program is a design to promote an efficient, competitive and sound banking sector in Turkey. A main objective of this banking reform program is the strengthening of private banking and the strengthening of the legal and regulatory banking environment.[8]

Question(s): To what extent have these reforms been implemented? What has been their impact? How many state banks have been privatized since the reform was initiated in March 2001? Has corruption in the banking industry been reduced as a result of this reform program?

Conclusion. Since the early days of the Cold War Turkey and the United States have shared (and continue to share) a close and mutually supporting relationship. Today America and Turkey continue to share a common "vital" national interest of regional stability. Turkey also shares the American concern in reducing the threat of global terrorism and continues to provide basing and support for the execution of containment missions against Iraq. Given the close and mutually supporting relationship, a strong and economically viable Turkey is a shared common interest of both countries. Given the financial crisis facing Turkey today, the significant steps that the three party coalition government has taken to put their country on the road to economic recovery (and prosperity) can only be seen as a positive step towards increasing their national economic strength while helping to ensure regional stability. It is in the best interest of the United States to help ensure the Turkish government remains true to its goals in economic reform, and continues to receive the support necessary to achieve it desired endstate.

.

[1] "Background Note: Turkey," Bureau of European and Eurasian Affairs, October 1999. Accessed at: http"//www.state.gov/r/pa/bgn/3432.htm. dtd 2/11/2002.

[2] http://proquest.umi.com/pqdweb?TS=1015263987&Did=000000099458547&Fmt=4&Deli=1&3/4/2002

[3] "Turkey: Industry & Inward Investment," FT.Com Financial Times, 18 April 2001. Accessed at http://surveys.ft.com/turkishindustry2001/index.html. dtd 2/11/02

[4] Zeyno Baran, "Corruption, The Turkish Challenge," Journal of International Affairs, Fall 2000, Vol 54 Issue 1, p127. accessed at: http://ehostvgw7.epnet.com/fulltex…ON%20%2d%2d%20Turkey%22&fuzzyTerm=. dtd 3/5/02

[5] http://www.state.gov/r/pa/bgn/3432.htm. Pg. 6. dtd 2/11/02.

[6] "Ataturk's Long Shadow," The Economist Newspaper Group, Inc., NY, NY., 10 June 2000, pgs 1-8.

[7] wysiwyg://bodyframe.64//http://ehos…ON%20%2d%Turkey%22&fuzzyTerm=. dtd 3/5/02.

[8] Anonymous, "Turkish Banking: Going in the Right Direction," Euromoney, London, August 2001, accessed at: http://proquest.umi.com/pqdweb?TS=1015264621&Did=000000078382661&Fmt=3&DelI=1&. dtd 3/4/02.